

A Quality, Growth, and Value Investment Strategy – The Quality Review Model

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Abstract: *A long-term, buy and hold investment strategy is reviewed in this paper, designed in many ways to emulate a passive held equity index. Emphasizing quality and growth characteristics purchased at value, the resulting portfolio would have low turnover and low tax impacts.*

Introduction. Value-oriented investment strategies have theoretical support in the literature (Graham, 1974; French and Fama, 1992; Chan & Lakonishok, 2004)), but in practice will typically suffer from underperformance once expense ratios, trading expenses, and tax impacts are factored in. The purpose of this working paper is to put forth an investment strategy, or model, that reviews the fundamentals of a business for quality considerations, growth characteristics, and valuation levels. The author at various places in this paper refers to the process as “The Quality Review Model”, or just the “Model”. References are also made to a theoretical “portfolio” of assets that are chosen through the strategies contained in this paper. No effort is made to generate a real portfolio that is evaluated through portfolio management measurements, although for purposes of asset selection, projected total returns on a risk adjusted can be entertained.

Preferred Investment Style. When making finance related decisions, an almost infinite number of investment styles exist to choose from. This Model essentially narrows the choice down to two styles – a combination of Growth and Value, but with a strong emphasis on quality considerations above all else. The Model is not meant to follow any neat or preconceived notion of any one particular finance theory or investment style, however. This Model is very much subject to continual review and change so as to accommodate a continual influx of new ideas generated from Finance Theories and/or practical, real world investing experiences. It may be called a “Model”, but the stock selection process is basically the practical side of long-term investment beliefs and philosophies.

Therefore, the focus is on quality, growth, and value characteristics of businesses. At all times, expense ratios of management should be closely watched and minimized, or else under-performance is almost pre-ordained, regardless of how brilliant the stock selection may be. Low turnover is highly preferred, with a buy and hold type of portfolio of high quality, growth oriented public equities, all purchased at reasonable to attractive prices. “Long-term” is defined as anything of five years duration or longer, so the target turnover rate is 20% or lower. While no attempt is made at being considered a tax-managed portfolio, the Model’s normal operation would likely generate low tax impacts. The selection of equities is made in a very deliberate manner, with a preference for only those superior equities expected to grow for 5 or more years.

Growth at a Reasonable Price (GARP) may possibly describe the Model's style, although a contrarian type of blend between growth and value styles may also adequately express the preferred pattern of investment. Due to the quality considerations of the model, large-cap businesses make up many of the firms on the 'Quality Review' list, but there is no specific market size required in the Model. The thoughts of numerous writers and financial commentators have influenced the Model's preferred style. These writers include Benjamin Graham, Phil Fisher, Warren Buffett, David Dreman, and the National Association of Investment Clubs (NAIC), among others. There is a reluctance however, to categorize the particular investment style involved, since any and all appropriate finance theories and styles are considered and regularly incorporated into the Model's framework.

The preferred style involves a bottom-to-top approach, whereby equities are considered one security at a time. While academic studies suggest that a top-to-bottom approach has great merit due to the identification of high growth economies and industries (Reilly & Brown, 2000, at 441), it is felt that the quality and growth parameters of the Model will limit the choices to many of the same high growth areas, anyway.

Thus, the portfolio that develops from this methodology will primarily be based on a long-term buy and hold type of philosophy and be composed of publicly traded domestic equities hopefully possessing superior quality, growth, and value characteristics.

Excluded Styles. While there is some hesitancy in labeling the Quality Review process with any one particular style of investment management, there are numerous styles that are deliberately excluded from consideration.

Short-term trading styles, day-trading, market timing, technical analysis, earnings surprises, or pricing momentum are all excluded from the Model. Absolutely no short-term pricing target types of variables exist in the Model – only the traditional PE and PEG variables are included in the Model, and these variables are used for valuation purposes only. Earnings surprises, Timeliness rankings, and momentum styled techniques play little or no part in a view of long-term investing, so they are not included here. Further, near-term trading activities are also considered rather irrelevant to the Model – 18 to 24 month pricing targets are expressly not generated by the Model. And, repetitive, buying and selling activities in near-term time frames are not contemplated by the Model, even if valid considerations exist. In general, equities will be held so long as growth and quality characteristics are present. If short or near-term considerations are desired by an investor, then some other model should be utilized.

Since the focus is on the selection of individual equities, the macro styles, including country, industry or sector orientations, are excluded from active consideration. International equities are not specifically sought out, but are not expressly excluded, either. In general, most of the equities chosen will have a significant domestic base of operation. Further, bonds, derivatives, alternative investments, and private investments are not typically within the investment universe of the portfolio.

Cash holdings will occur through the normal operation of the portfolio, but will generally be considered incidental to the objectives of the Model. Once a qualifying investment is found, the portfolio will normally invest cash reserves into the investment. There may be times in the operation of the portfolio however, that significant cash reserves will be held, depending upon whether suitable investments can be located.

Similar Styles. Since various Indexes are designed to be buy and hold in nature and with low turnover and transaction expenses, there are some similarities between the Model and investment philosophies favoring Indexes. The Model involves individual stock selection, chosen one business at a time, and the Quality review process could serve as a supplement to the Indexes. An investor could start off with a broad market Index, and then begin selecting individual stocks from there. Over time, the portfolio would become over-weighted in growth and value styled equities that will then all hopefully outperform the relevant Index. The Index returns could possibly be increased through the careful selection of individual growth and quality types of equities – at least in theory. An “enhanced” type of Index could thereby be ultimately developed (see Rice & Schnank, for a review of enhanced indexing). An Index could serve as the core of equities during a portfolio’s early development, with the selection of individual securities becoming more important to the portfolio as it matures over time. Risk adjusted return variables can be included in the Model’s output, so as to develop meaningful data for a comparison to an enhanced index style.

Another similar method is that of the Quality rankings system of Standard & Poors. The S&P rankings, which based on superior earnings and dividends, have outperformed on both an absolute and risk adjusted basis, and with lower amounts of variance and semi-variance or downside risk (S&P Report on Earnings & Dividend Ranking System, 2003). The Model reviews the S&P Quality rankings, as well as other analyst opinions, in initially identifying promising equities for further consideration. The actual selection of equities by the Model is also dependent upon value considerations, so not all highly ranked equities based on S&P Quality will become a part of the Model’s portfolio, however.

Statistical research has also shown that businesses with market leadership positions have outperformed the S&P 500 on an absolute and risk-adjusted basis (O’Shaughnessy, 1998, at 47-54). The Model attempts to identify and select such market leaders.

Asset Allocation of the Model. The Model assumes 100% public equity investment levels, since over the long run, equities have historically offered higher rates of return than bonds and cash instruments. If an investor desires an allocation with a broader mix of investments, such as defined percentages of cash, bonds, or income stocks, the investor should utilize a more balanced allocation of assets. The Model would be directly applicable to only that portion of an investment portfolio devoted to publicly traded growth and value styled equities.

Diversification of the Model. The Model does not expressly attempt to diversify by industry, sector, or national economy. It merely seeks to identify those equities that are possible buy candidates on the basis of long-term quality and growth features, and then to further identify securities for purchase based on value parameters. Since diversification concepts are important, a basic attempt is made to broaden the recommended lists of equities beyond merely a few high-growth industries. The percentages of a portfolio devoted to any one industry or sector can be noted, but is not critical for the Model's operation.

Risk/Reward Factors of the Model. It is generally agreed that traditional notions of risk versus return trade-offs are applicable (Markowitz, 1952, 1959). In order to obtain higher levels of returns, an investor has to bear higher levels of risk. More current research, however, suggests that risk-return trade-offs are time correlated (Siegel, 1998; Kaufhold, 2005). Instead of a two dimensional portrayal of risk versus return, the risk analysis must be conducted for any given rate of return in any given time frame. Thus, the trade-off in actuality involves a three dimensional array of choices between risk, return, and time, with risk and return definitions shifting by the very long-term (Kaufhold, 2005).

The Model uses the Treynor measure of risk adjustment, since the technique is easy to collect data on and to then calculate results (for a review of the various types of risk adjustment, see Reilly & Brown, 2000). The Sharpe and Jensen ratios could also be developed for risk adjustment purposes. Enhanced Indexes make ideal vehicles in which to use risk adjusted return concepts, because such "Indexes" reduce volatility through diversification, and yet still provide for the active management of assets. The overall goals would be to outperform the relevant Index on a risk-adjusted basis. The Model can select for a risk-adjusted rate of return to be used in conjunction with an enhanced index or for the selection of individual equities, for those assets to be held for 5 years or longer. The Model uses standard deviation calculations for a 5 year time horizon, since that is the minimum holding period intended for assets selected by the Model.

Note on Short-Term Trading. The Model ideally should function in the long run, as pricing risk is minimized over long time references. If an investor is using the Model for short-run investments however, volatility risk comes into play. All investors should be aware that the Model may generate candidate buys on quality oriented, growth-styled equities, almost all of which could have Betas higher than the S&P 500 Index average of 1.00. With such heightened volatility, investors may quite easily experience pricing losses of significant amounts in the short-run. Only risk tolerant investors should use this Model, or any growth-oriented style for that matter, for short-term activities. If an investor insists on growth investing in the short-term, the investor must be ready to assume extraordinary losses. This Model is not recommended for short-term frames of references. The Model contains no short-term pricing related variables but does contain value-oriented data. The overall effect of the Model in short and near-term frames may be to 1) take no advantage of short-run momentum related pricing surges, while 2) concurrently under-performing the marketplace temporarily in order to secure out-of-

favor value-styled opportunities. Therefore, this Model is better suited for the long-term investing preferences.

Note on Long-Term Investing. By adding the dimension of time into the risk/return equation, market-pricing volatility risk is largely controlled and substantially reduced. Recent studies indicate that the adverse effects of volatility risk are largely avoided by long-term investment activities, and without a corresponding reduction in returns (Siegel; Kaufhold). When one considers historical time frames, stocks have consistently generated higher rates of return than bonds, and with small amounts of risk. Volatility risk may not even exist in the very long-term of 25 years or more. Bogle (1999) estimates that standard deviation may be only 2% for a 25 year hold, and 1% at a 50 year time horizon. This is opposed to 16% for a 1 year hold.

Thus, in the long-run, volatility risk is smoothed out and gives way to predictable patterns of equity pricing correlating to the underlying economic performance of the business at issue. In one study, the correlation between pricing and earnings was .688 for an 18 year period. (Hagstrom, at 74-76). By looking at the quality statistics of a business, the likely amount of pricing increase to an equity can possibly be determined and predicted with some degree of success. By concentrating on companies with good quality features, the Model may produce a reduced level of volatility risk, at least in the long-run. This is consistent with research suggesting that value-oriented investment styles could potentially outperform that of the overall market (Chan and Lakonishok, 2004), leading to an eventual reversion to the mean in pricing performance as well as lower pricing risk.

While diversification and asset allocation may still be important in very long time horizons, the chief focus of the Model is to generate superior returns, and with pricing risks that are smoothed out both by time itself and by the company's ability to generate consistent revenues, earnings, cash flows, and book values. The emphasis is not on variance minimization as much as on individual stock selection appropriate for long-term holding periods.

Note on Value Investing. The Model generally strives to select equities on the basis of attractive valuations, and thus may be said to be a value-oriented strategy. There are any number of value style approaches, however. Many of these strategies are near-term in nature, whereby a selection is made on the basis of an apparent under-valuation, and then held onto only until a full valuation level is achieved. Often, the financial or managerial quality of the asset may be questionable, but valid reasons may still exist for an eventual return to a higher valuation levels.

Since the Model takes a long-term view of investing, quality becomes more paramount, with the initial screen eliminating businesses that do not possess superior economics and management. The "deep value" opportunities may therefore be missed by such an emphasis on quality. Investors who are interested in such a style should select other strategies and models. Because the focus of the Model is on quality characteristics, the portfolio of equities ultimately chosen will tend to have low turnover, low tax impacts, and be kept for so long as quality continues to exist in the assets chosen. While a time

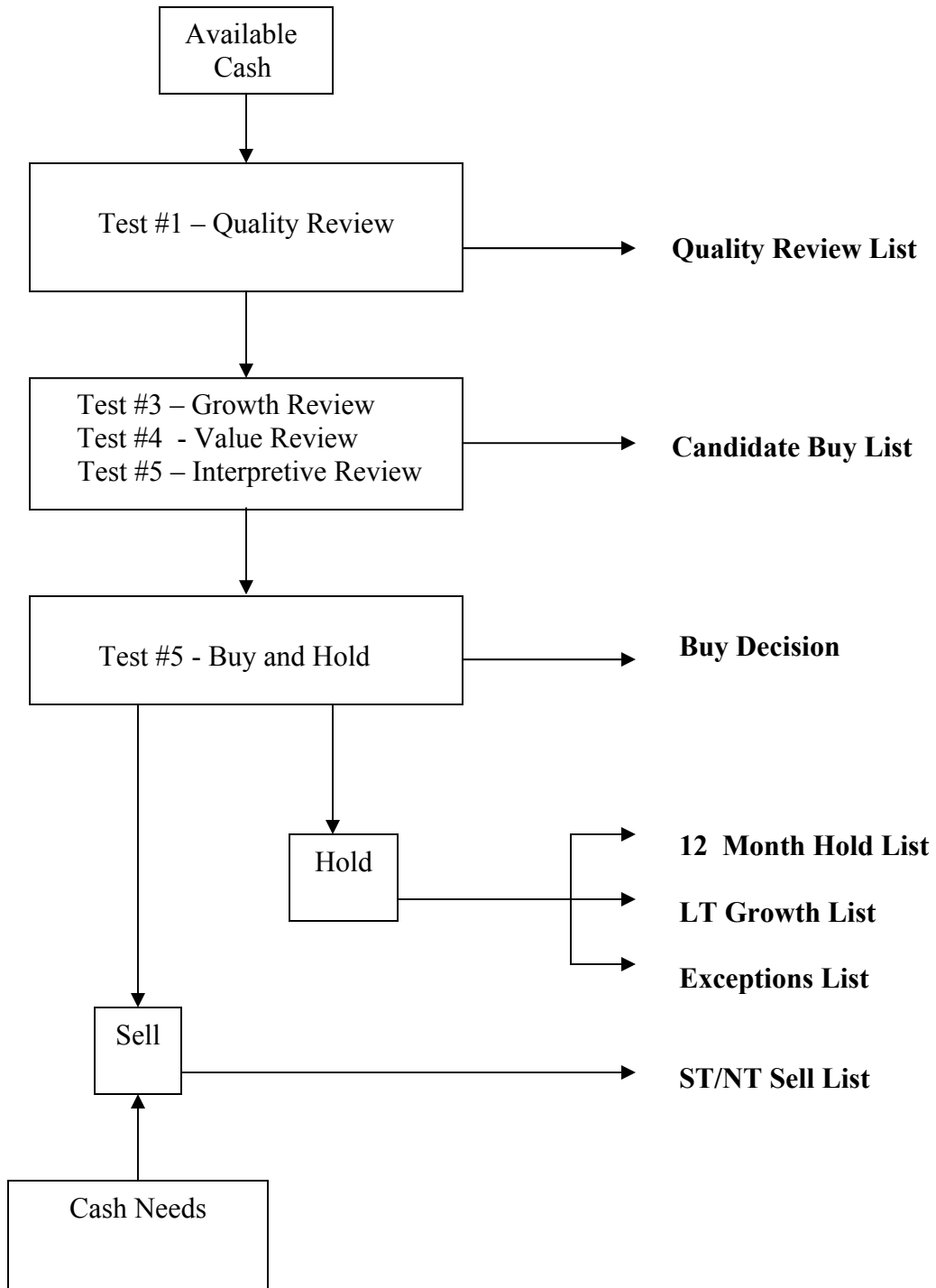
frame somewhat shorter than Warren Buffett's "permanent holdings" is envisioned by the Model, the goal is to select only those equities that possess such superior quality characteristics that they can be held into the long-term with some amounts of confidence.

With the Model concentrating on quality characteristics obtained at value, any portfolio ultimately chosen through the Model's precepts would be ideally suited for cash accounts, where tax impacts would be minimized through low turnover. For accounts where turnover is not an issue, the Model could eventually be expanded to include a greater emphasis on pure value, especially where "catalyst" activities on a business would be occurring that might cause pricing to return to higher levels.

Note on Benchmark Index. A criticism of some indexes, such as the DJIA or the S&P 500 is that the indexes themselves are individually chosen for inclusion or eventual exclusion from the index. The preference therefore is to have as broadly based index as possible, so as to capture the entire domestic economic experience rather than a committee's view of what "industrials" or quality, large caps should comprise. The Wilshire 5000 is such a broad based index that does not involve active selection of equities for inclusion or exclusion into or from an index, beyond the initial qualifications (in the case of the Wilshire 5000, domestic equities that are publicly traded on either the NYSE, AMEX, or NASDAQ, but not OTC or pink sheets). Bodie, Kane, and Marcus (2004) recommends to use a real fund that tracks the Wilshire, such as the Vanguard Wilshire 5000 fund, since an investor cannot actually invest in an index, but only an index fund, along with its expense ratios and turnover experience. The benchmark index fund that is therefore used for comparison purposed to the Model is the Vanguard Total Stock Market Index Fund (VTSMX).

Methodology. The core of the Model revolves around a subjective interpretation of several variables, all of which are detailed below. The Model "tests" companies for these variables, and those firms passing all of the tests will be then be given further attention as a possible buy. If a selected business eventually begins to fail one or more of the tests, it may possibly then be considered a sale candidate. The testing process of the Model follows the quality, growth, and value aspects mentioned in this document.

Flow Chart. The Model can be visually portrayed by the following:



Explanation of the Flow Chart. The following comments on the above referenced flow diagram further describe the Model's testing of certain parameters.

Test #1 – Quality Review. First, businesses are reviewed for their quality features. Strong ROE's, profit margins, ROIC's, Debt to Equity Ratios, and Financial Ratings are all preferred. Especially interesting are firms that have outperformed the industry on a consistent basis and are currently outperforming its own historical record. Strong financial ratings, earnings predictability, and strong cash flow ratios are also very desirable. In particular, cash flow ratios are very important. Free cash flows are not as easy to manipulate as earnings, and research suggests that poor cash flows are the most critical determinant of default. Conversely, strong free cash flows epitomize a fundamentally solid company.

Companies possessing superior quality features will be vibrant and strong, probably with market leadership positions and competitive advantages. Examples of desired financial out include: 15% ROE; 7% net profit margin; 10% ROIC; and a 1:1 Debt to Equity ratio. While all of these numbers are somewhat arbitrary in nature, and must be varied by industry, they at least set the tone of what is "quality". These numbers are not definite cut-off figures, but are general non-pricing targets. The more that exceptions have to be made to these ratios, and the more that the company is below industry or historical averages, the less likely will a business be reviewed further.

Those businesses passing quality tests will then be followed rather closely. Some of the firms followed will possibly outperform and have wide "moats" over portions of the US economy for many years to come. The entire universe of stocks that are regularly followed by the Model are composed of a very few and select number of growth businesses having exceptional quality.

Test #2 – Growth Review. For this test, a preference is made for companies that are growing in terms of revenue stream, cash flows, earnings, dividends, and book values. Consistency of past growth is desired, for it ensures predictability in the growth phase of the company. Future growth parameters are also reviewed. Revenues, cash flows, earnings, book values, and free cash flows are closely watched. Earnings growth may be over-estimated by many analysts and/or companies. (Dreman, at 97-100). Since the earnings growth estimates can circumspect at times, growth in free cash flow is also closely reviewed. The emphasis is given to what the company is doing with its earnings and cash flows – is it further increasing its book values, cash flows, and revenue stream? Is it adding anything of real value? Or, is it merely acquiring businesses without adding anything of value? These are central questions.

Test #3 – Value Review. Assorted value parameters are reviewed in this step. For instance, a company's TTM PE, future projected PE, and its historical PE ratio as well as the industry's PE is ascertained. All other price to value indicators are reviewed in a similar fashion. Intrinsic valuation estimations are further entertained. "Expectations" value" is also entertained. A DDM model and the present value of the free cash flows are

utilized to determine valuation through intrinsic measures. Of particular interest are those firms that can appear undervalued by all or most value parameters.

Each of the companies on the Quality list are ranked from highest projected total return to lowest return. The projected return is annualized over the next 5 years, and no thought is given to ST or NT return projections. The ranking is done on an absolute return basis and a risk-adjusted basis. 5 year standard deviation numbers are typically used, as this is the minimum target hold period.

Test #4 – Interpretive Review. Output from the first three tests can be generated rather automatically from a computer screening program. The fourth test is qualitative in nature. This test incorporates all of the skills of the analyst, and forces a recommendation on the basis of a general feeling – not on mere statistics. While financial ratios are always important, the central question of this test is whether a person would want to personally own the business, if it could be purchased directly and completely.

Associated questions include the following. Would this be a place that deserves the hard earned cash of an individual investor? Can the business be entrusted to grow and consistently turn in superior economic performances for many years to come? Does the company have a superior product? Does it generate value to the customers? To the Shareholders? Will the company's overall value and wealth continue to increase? Does the business have integrity and honesty? Can the management be trusted to act in the best interests of the shareholders? Or will they merely use the firm as a corporate fiefdom, only enriching themselves and their close allies? Can the management be trusted? What do the employees think of the business? What do competitors think of the business? Service vendors and the supplier of goods? The customers?

Most importantly, would an investor be proud of owning the business, or embarrassed by it? The answer determines whether this test is passed or failed. Firms that possess quality, growth, and value characteristics as well as clearing the subjective interpretive test are placed on a candidate buy list, ranked by projected total return.

Test #5 – Buy and Hold. Once a buy occurs, the equity will be held for a minimum of 1 year, to avoid the short-term capital gains tax rate. The stock will be placed on the 12 month hold list. The equity will be continue to be held beyond 12 months so long as quality and growth features are still exhibited. Note that value considerations are no longer paramount. A hold generally occurs so long as quality and growth parameters are satisfied. In fact, additional buys may be entertained if the business continues to be under-valued. A sell may occur on the basis of over-valuation, but this would be extraordinary in nature, and would normally occur only if the extent of overvaluation becomes excessive on an intrinsic and relative basis.

The Model attempts to keep capital gains in an unrealized state, to take full advantage of compounded returns. Eventually, all companies will slow down out of their growth phase, and some companies may slip out of a “quality” state of existence. So long as the company is still adding to its net worth by vast amounts, the business will generally be

held. These businesses are so few and far between. And, buying a growth company at an initial discounted price is even rarer still.

The actual buy decision will have to sort out still more considerations of a subjective nature. Diversification, allocation, and weighting concepts come into play, as well as the likely long-term overall rate of return from any company on the candidate buy list. While diversification is considered at this step, it is not overly critical. All things otherwise being equal, a stock from the candidate buy list may be purchased to diversify somewhat. If the returns of some other stock on the buy list are projected to be superior, however, the other company may still be purchased. Essentially, all of the equities are reviewed, and the field is narrowed down to an actual buy based upon solid, financial concepts.

After the first 12 months of purchase, the company will then be placed on a LT Hold List, assuming that the company still meets or exceeds the Model's requirements. Occasionally, a company will no longer meet required growth or quality parameters but will still be held onto for a while. This occurs in cases where the stock is likely to increase in price in the near-term due to investor psychology, talks of mergers, or merely a realization of full value. Such stocks go on an Exceptions Hold List. They do not meet growth or quality requirements, but there is an exceptional reason to continue to hold them. Thus, the Exceptions Hold List.

Sale Procedures. If quality is no longer present, the business will be targeted for a sale from the portfolio. Also, as noted above, if the business is so overvalued that its projected total return is very low (and far down on the Quality list, by projected total return), a sale may be entertained even if quality is still present. The stock is placed on a ST/NT sell list. A sell limit order is executed, unless there is a peculiar reason to move to a market order (usually due to cash needs or due to ST market volatility considerations). If there is a risk of a no-sale, the market price may be met. If there is no critical need of cash right away though, a limit price can be set. If the asset doesn't sell at the price set, then the market price can always be resorted to later.

If cash is needed – as in a redemption – then the flow chart works in reverse. First, cash on hand in the portfolio is exhausted. Then, the Model works its way through the various lists in reverse order. The ST/NT Sell list will be reviewed for a likely candidate to liquidate. These equities are in the process of being sold anyway. Things are merely speeded up a bit by moving to a market order. The Exceptions Hold list is reviewed next, since these companies no longer meet LT quality parameters. Then, if there is still a need for cash, the LT Growth Hold list is accessed. Lastly, an almost complete liquidation from public equities would eliminate the 12 month hold list.

Shorting Activity. While the Model has a long-term buy and hold philosophy to it, ranking the Quality list by projected total returns will generate not only possible buys, but may also lead to situations where over-valuation is readily apparent. Those equities at the bottom of the ranking, if held in the Quality portfolio, may become sale candidates on the basis of over-valuation. For those equities not held in the portfolio but that are otherwise being tracked on the Quality list, the lowest projected returns might be so

overvalued that they could potentially become shorting candidates. While the Model is not designed for shorting or hedging activities, the Quality list does at least generate statistical estimations of gross over-valuations. There could be times in which emotions get the best of investors, and pricing on selected equities could be bid to ridiculous levels. The exact timing of a pricing decline would still be at issue, so it would be problematic as to whether an investor could take advantage of the situation. But, the list would at least signal which businesses should not be bought (or sold, if already owned) on the basis of valuation characteristics.

Conclusion. The Quality Review Model produces a very exclusive list of companies to consider. Instead of relying on ST and NT quant or momentum models, the Model ends up choosing only a very few number of companies possessing quality characteristics, LT growth prospects and reasonable current valuation levels. Growth and value variables are balanced through reliance on solid fundamental business characteristics. While it is debatable whether any actively managed portfolio can consistently outperform its benchmark index on a post-tax, post-expense basis, the Model described here emulates the long-term buy and hold, low turnover style of a passively managed index. By developing a portfolio based on the features noted in this paper, the Model essentially generates its own “index” of equities composed of company with exceptional performance, all hopefully purchased at value.

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